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Issues: Payroll Expense; Incentive
Compensation; Employer
Health, Dental and Vision
Expense

Witness: Dana E. Eaves

Sponsoring Party: MoPSC Staff

Type of Exhibit: Rebuttal Testimony

Case No.: ER-2004-0034

Date Testimony Prepared: January 26, 2004 as modified February 27, 2004

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

FILED

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REBUTTAL TESTIMONY Missouri Public
Service Commission

OF

DANA E. EAVES

AQUILA, INC.

AQUILA NETWORKS-MPS-ELECTRIC

CASE NO. ER-2004-0034

*Jefferson City, Missouri
January, 2004*

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Aquila, Inc. d/b/a Aquila Networks)
L&P and Aquila Networks MPS to implement a) Case No. ER-2004-0034
general rate increase in electricity.)

AFFIDAVIT OF DANA E. EAVES

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Dana E. Eaves, of lawful age, on his oath states: that he has participated in the preparation of the following rebuttal testimony as modified on February 27, 2004, in question and answer form, consisting of 15 pages to be presented in the above case; that the answers in the following rebuttal testimony as modified on February 27, 2004, were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.



Dana E. Eaves

Subscribed and sworn to before me this 27th day of February 2004.





TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

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1 **REBUTTAL TESTIMONY**

2 **OF**

3 **DANA E. EAVES**

4 **AQUILA, INC.**

5 **d/b/a AQUILA NETWORKS-MPS ELECTRIC**

6
7 **CASE NO. ER-2004-0034**

8
9
10
11 Q. Please state your name and business address.

12 A. Dana E. Eaves, PO Box 360, Suite 440, Jefferson City, MO 65102.

13 Q. By whom are you employed and in what capacity?

14 A. I am a Regulatory Auditor for the Missouri Public Service Commission
15 (Commission or PSC).

16 Q. Are you the same Dana E. Eaves who has previously filed direct testimony in
17 these cases?

18 A. Yes, I am. On December 9, 2003 I filed direct testimony on the subject of
19 payroll and payroll related expenses in both of these cases.

20 Q. What is the purpose of your rebuttal testimony?

21 A. The purpose of my rebuttal testimony is to address the direct testimony of
22 Company witness Ronald A. Klote who sponsors the inclusion of an April 1, 2004 union
23 salary increase and a proposed incentive compensation adjustment (CS-6). Staff would
24 characterize these isolated "out of period" adjustments as being unique and unusual. These

1 adjustments are not proper ratemaking adjustments to the test year and violate the “known
2 and measurable” principle as practiced by this Commission in the past. This testimony will
3 also address the direct testimony of Company’s witness Stephanie A. Murphy who sponsors
4 the Company’s adjustment (CS-12) to health, dental and vision expense. The Staff disagrees
5 with the level of expense proposed to be included in the case for this item.

6 Q. Please explain the Staff’s positions that will be addressed in this testimony.

7 A. The Staff is *not* recommending the inclusion of an April 1, 2004 union salary
8 increase or the incentive compensation adjustment requested by the Company. The Staff is
9 proposing and supporting an adjustment to the self-insured portion of the Employer Health,
10 Dental and Vision expenses.

11 Q. What test year is being utilized in this case?

12 A. On July 3, 2003, Aquila, Inc. filed this rate increase application seeking to
13 increase existing revenues. The Commission’s Suspension Order and Notice for these
14 proceeding states, “the parties propose the 12-month period ending December 31, 2002, as
15 the test year.” Therefore, the test year being used in this case is the 12-months ending
16 December 31, 2002. The Commission Ordered that a test year update period, also known as
17 a “known and measurable” period, be used to reflect material changes to the revenue
18 requirement that occur subsequent to the test year through September 30, 2003.

19 Q. What is the purpose of the test year?

20 A. The purpose of a test year is to identify a 12-month period to serve as the
21 starting point for review and analysis of the utility’s operations to determine the
22 reasonableness and appropriateness of the rate filing. The test year forms the basis for any
23 adjustments necessary to remove abnormalities that have occurred during the period and to

1 reflect any increase or decrease to the utility's accounts. Adjustments are made to the test
2 year level of revenues, expenses and investments to determine the proper level of investment
3 on which the utility is allowed the opportunity to earn a return. After the recommended rate
4 of return is determined for the utility, a review of existing rates is made to determine if any
5 additional revenues are necessary. If the utility's earnings are deficient, rates need to be
6 increased. In some cases, existing rates generate earnings in excess of authorized levels,
7 which may indicate the need for rate reductions. The test year and known and measurable
8 update periods are the vehicles used to evaluate and determine the proper relationship
9 between revenue, expense and investment at a point in time. Establishing a proper
10 relationship between these three revenue requirement elements is essential in determining the
11 appropriate ongoing level of earnings for the utility.

12 Q. How can historical test year be adjusted to reflect the ongoing prospective
13 nature of ratemaking?

14 A. The Staff proposes annualization and normalization adjustments to the test
15 year for this purpose.

16 Q. What are annualization adjustments?

17 A. Annualization adjustments pertain to events that have occurred within the test
18 year and will continue to occur subsequent to the test year. Annualization adjustments reflect
19 the forward-looking dollar impact of recurring test year events. They are generally used
20 whenever the data for a revenue or expense component shows a definite trend upward or
21 downward within a test year. In that situation, an annualization adjustment would normally
22 be proposed to reflect the most recent values within the test year for that revenue or expense
23 component for inclusion in rates.

1 Q. What are normalizations adjustments?

2 A. Normalization adjustments reflect the removal of events or items within the
3 test year that are non-recurring, or exhibit a fluctuation from the level, which would be
4 normally expected to occur. Normalization adjustments need to be made to the test year to
5 achieve the appropriate forward-looking focus of the investment/revenue/expense
6 relationship.

7 Q. Did the Company propose a true-up in this case?

8 A. No. The Company did not propose a true-up in this case. Instead the
9 Company has proposed isolated adjustments to its case that represent "out-of-period"
10 adjustments that will be addressed later in this testimony.

11 Q. What is the purpose of a true-up?

12 A. A true-up audit involves the adjustment of historical test year figures for
13 known and measurable revenue requirement changes subsequent to the test year and update
14 period.

15 A true-up is intended to capture very significant events that occur beyond the known
16 and measurable update period but prior to the effective date for rates for the proceeding. An
17 example of a significant event justifying a true-up has been the addition of a new generating
18 station with an in-service date after end of the update period. As with the update period, a
19 true-up audit requires that all significant costs of service components be measured as of the
20 true-up date in order to maintain the matching of revenues, expenses, rate base investment
21 and cost of capital.

22 Q. What is the "known and measurable" concept, as that term is used in the
23 ratemaking process?

1 A. The concept of “known and measurable” refers to setting of rates based on
2 actual items or events that occur related to providing utility service, that result in material
3 changes to the revenue requirement. These actual events have a material impact on the
4 revenue, expense and rate base investment relationship that the Commission has consistently
5 used in determining the rates that utilities operating in the state of Missouri can charge their
6 customers for utility service. These changes take place as of the end of the update period and
7 must be “known,” or certain to occur; and must be quantifiable, or capable of being
8 “measured” by an audit process (i.e., that the item or event can be quantified). The
9 Commission has maintained that an item or event is known and measurable when an event
10 has occurred, is measurable as to quantification and can be documented through support by a
11 verification or audit process. An example of the sort of documentation would be the books
12 and records of the company, in particular the audited financial statements of the company.

13 Q. Did the Commission stress the importance of maintaining proper balance
14 between the costs of service items in these cases?

15 A. Yes. In the Suspension Order and Notice issued July 22, 2003, the
16 Commission stated at page 2 that the Commission will not consider a true-up of isolated
17 adjustments, but will examine only a “package” of adjustments designed to maintain the
18 proper revenue-expense-rate base match at a proper pointing [sic]in time.” [Re: Kansas City
19 Power & Light Company, 26 Mo. P.S.C. (N.S.) 104, 110 (1983)]

20 **PAYROLL ANNUALIZATION**

21 Q. Is the Company requesting to seek the inclusion of a union salary increase
22 outside of the test year and update period?

1 A. Yes, the Company has included a union salary increase due to take effect
2 April 1, 2004.

3 Q. Did the Staff include any payroll increases for the Company in its payroll
4 annualization?

5 A. Yes. The Staff included March 1, 2003 salary increases of 2.77% for non-
6 union employees, an April 1, 2003 MPS union salary increase of 2.5%.
7 Because of the use of the latest known actual payroll
8 information, including wage rates, as of September 30, 2003, the payroll calculation has in
9 effect included these salary increases in the Staff's annualized payroll adjustments. These
10 increases have actually occurred so the Staff has been able to verify that they occurred and
11 can calculate the actual effect the increases have to the payroll annualization. The Staff
12 annualization of payroll considered the actual salary and wage rates were applied to actual
13 level of employees as of September 30, 2003. Thus, the payroll annualization was based on
14 "known and measurable" concepts.

15 Q. Please explain the methodology you employed to determine annualized
16 payroll.

17 A. The annualized payroll is based upon the Company's employee levels at
18 September 30, 2003. The wage rate and salary levels are based upon straight time
19 wages/salaries according to the most recent information available through the end of
20 September 30, 2003. Hourly wages were computed for hourly workers using 2,080 hours,
21 which represents the number of work hours in a year based on the 12-month period ending
22 September 2003. Salary and wage rates are computed on an annual basis as of September 30,
23 2003.

1 Q. Why were these wage/salary rates and employee levels at September 30,
2 2003, used to calculate the payroll annualization?

3 A. These levels represent the most current actual information relating to ongoing
4 payroll expense. Using actual information as of September 30, 2003, which is the end of the
5 update period in this case, provides the most current information that is available regarding
6 employee levels, wage rates and salaries. Use of this information at this point in time is
7 consistent with other aspects of this case such as the revenue annualization and rate base
8 investment, and is consistent with the ratemaking principle of maintaining the proper
9 relationship of revenues, expenses and investment at a point in time.

10 Q. How did you determine total annualized payroll?

11 A. The sum of the annualized components discussed above (full-time union, non-
12 union hourly, salaried, and part-time payroll) represents the annualized payroll being
13 proposed by the Staff in this case.

14 Q. How did the Staff determine the allocation of the total payroll costs between
15 total Company expense, construction, retirements, non-regulated activities and clearing
16 accounts within the electric utility operations?

17 A. The total Company expense allocation was derived from data requested from
18 the Company, which identified the capitalization and expense payroll ratios and the accounts
19 charged.

20 Q. How did the Staff determine the portion of annualized payroll to be charged to
21 the Company's total company expense?

1 A. I multiplied total annualized payroll by total Company expense factors to
2 derive total annualized payroll to expense. Total annualized Company payroll was then
3 distributed to expense functions based upon the actual distribution of test year payroll.

4 Q. Does the Company's proposal to include the April 2004 union salary increase
5 in cost of service represent an "isolated," out of period adjustment?

6 A. Yes. The Company's proposal does not consider all of the relevant factors
7 that are necessary to make adjustments to the revenue requirement that must also be included
8 in order for a proper relationship of revenues, expenses and rate base to be maintained.

9 Q. Why is it not appropriate to go outside the known and measurable period
10 and/or true-up period to consider cost increases for inclusion in rates?

11 A. To do so would violate the "test year" matching concept. It is critical in
12 developing a rate structure to maintain a consistent relationship between the revenues
13 recognized by the Company with the expenses incurred to generate those revenues and the
14 rate base investment needed to serve a customer level at a point in time. Properly reflecting
15 the revenue/expense/rate base relationship at a point in time is known as the "matching"
16 concept. The Staff has maintained this critical relationship in its calculations of the
17 annualizations and normalizations used in developing its recommended revenue requirement
18 in this case. In order to maintain the proper relationship between revenue/expense/rate base
19 investments, the Staff has or will include material changes to all significant components of
20 the revenue requirement determination through the end of the known and measurable period
21 and the up-date period. By including all material known changes in revenues, expense and
22 rate base through the end of these periods, an appropriately matched relationship for these
23 elements of revenue requirement is maintained for purposes of setting rates. Revenues have

1 | been normalized and annualized through September 30,2003 (the update period) to reflect the
2 | increased number of customers to which the Company provides electric service. Expenses
3 | have been updated to reflect costs that will be incurred as of these cut-off dates. The rate
4 | base investment included in the Staff's case is consistent with the level needed to serve the
5 | customers at the end of the test year update and up-date periods. All the annualization and
6 | normalization adjustments made in the case are intended to maintain this critical relationship
7 | in establishing rates.

8 | As an example, while the Company is experiencing increases in payroll for salary and
9 | wage increases, it may also be experiencing cost reductions in other areas and/or additional
10 | revenue from customer growth. The Company's proposed inclusion of the April 2004
11 | payroll increase violates the matching principle because it fails to recognize additional
12 | changes to cost of service like revenue growth from October 2003 to April 2004 which
13 | would offset the cost of the payroll increase in whole or in part. Both the test year update
14 | period and the true-up period are devices traditionally employed by the Commission to
15 | reduce regulatory lag, which is the lapse of time between a change in revenue requirement
16 | and the reflection of that change in rates.

17 | Q. Has the Staff arrived at a conclusion on the rate treatment of the Company's
18 | proposed April 1, 2004 union salary increase?

19 | A. Since the parties have not agreed to a true-up allowing for a matched update
20 | encompassing all major components of revenue require requirement and the Commission has
21 | not ordered one, the Company's proposed isolated adjustment for payroll seven months
22 | beyond the update period should be rejected.

23 |

1 **INCENTIVE COMPENSATION ADJUSTMENT**

2 Q. Has the Company proposed to include an amount for incentive compensation
3 in the current rate case?

4 A. Yes. The Company is proposing adjustment (CS-6) for recovery in rates by
5 the Company's ratepayers of MPS-electric: \$605,620.

6

7 Q. What is the staff position on the incentive compensation adjustments proposed
8 by the Company?

9 A. The Staff opposes the adjustment based upon two major factors: (1) the
10 proposed adjustment does not meet the "known and measurable" standard; and
11 (2) measurement is based upon improper goals (platforms).

12 Q. Does Mr. Klote's adjustment represent an estimate of a future payout of
13 incentive compensation in this case?

14 A. Yes. Mr. Klote makes no representation in his direct testimony that the
15 amounts represented in his proposed adjustment will actually be paid out to employees.

16 Q. Does the Staff agree with how this adjustment was calculated?

17 A. No. Mr. Klote has calculated an estimate based upon all current employees as
18 of September 30, 2003 achieving the middle level of possible incentive payouts in a normal
19 year. Under the Company's scenario, all employees employed at September 30, 2003 would
20 receive the minimum of the mid-level incentive payout regardless of whether the employee
21 met their individual criteria or not.

22 Q. Did the Company have an incentive compensation plan in effect for the 2002
23 plan year?

1 A. Yes, it did have an incentive compensation plan referred to as the 2002
2 incentive compensation plan.

3 Q. Did the Company make any incentive compensation awards to employees for
4 the 2002 incentive compensation plan during the test year or the update period?

5 A. No. The Company made no rewards based on the 2002 incentive
6 compensation plan.

7 Q. Did the Company suspend the 2002 incentive plan?

8 A. Based upon the Company's response to Staff Data Request 317.1, the
9 Company suspended the plan.

10 Q. Has the Company made any statements in regards to why it suspended the
11 2002 incentive compensation plan?

12 A. Yes. Aquila, Inc.'s 10K Report to the Securities and Exchange Commission
13 (SEC) for the fiscal year ended December 31, 2002 filed by Aquila with the on April 15,
14 2003 states on page 121:

15 Our Long-Term Incentive Plan (LTIP) enables the company to reward
16 key executives who have an ongoing company-wide impact. Eligible
17 executives are awarded performance units based on a comparison of
18 out total shareholder return over three years to a specific group of
19 companies with operations similar to ours. Incentives have been paid
20 in cash, restricted stock, restricted stock units or deferred
21 compensation agreements funding stock option grants based on the
22 executives' total shareholdings of the company common stock and
23 their elections. Total compensation expense for the years ended
24 December 31, 2001 and 2000, was \$19.6 million and \$8.5 million,
25 respectively. Due to the Company's 2002 performance, no awards
26 were earned for the year ended December 31, 2002, no new awards
27 were granted in 2002, and potential awards for the year ended
28 December 31, 2003 were suspended.

29 Q. Has the Company developed a new incentive compensation plan for 2003?

1 A. Yes. This plan is outlined at pages 5 thru 9 of the direct testimony of
2 Company witness Klote.

3 Q. Is there any certainty that the Company will make incentive compensation
4 awards under that plan in 2004?

5 A. No. Since no rewards were made for the 2002 plan, there is a possibility that
6 the Company may decide again not to make rewards in 2004 for the 2003 plan. This
7 possibility is referenced in the section of the Company's 10K filing I quoted earlier.

8 Q. Has the Company meet the "known and measurable" standard as described
9 earlier in testimony for its adjustment to incentive compensation?

10 A. No, the Company does not know with any certainty the actual date or level of
11 payout to be given to employees. The Staff's position recognizes the possibility that no
12 awards will occur as happened with the Company's 2002 plan. Therefore, the Staff contends
13 the Company's adjustment (CS-6) is neither "known nor measurable."

14 Q. Is the Staff opposed to charging Missouri customers of Aquila, Inc. for
15 incentive payments relating to achievement of certain financial performance goals?

16 A. Yes. In the direct testimony of Mr. Klote, he describes on page 7, lines 11-19
17 the incentive performance goals:

18 The incentive pay plan beginning in 2003 will be tied to the following
19 organizational objectives, which Aquila feels are critical to all
20 stakeholders. They include:

- 21 • Customer Service
22 • Reliability
23 • Effective Use of Capital
24 • Safety

25 Aquila's performance in each of these areas will be measured to
26 determine what incentive level an employee is eligible for during the
27 reporting period. Then, based on the employee's performance in

1 regard to their personal goals, an annual incentive payment is
2 calculated.

3 Q. How does the Company define the effective use of capital measured?

4 A. The Company defined effective use of capital in its response to the Staff Data
5 Request No. 317 as “budgeted EBITDA less capital expenditures measured by state
6 jurisdiction”.

7 Q. What is “EBITDA?”

8 A. EBITDA is defined as earnings before interest, income taxes and depreciation
9 and amortization. This is a financial measure that relates to the earnings cash flow of a
10 company.

11 Q. Who are the beneficiaries of maximizing cash flow and earnings?

12 A. Shareholders. That is why the cost of the incentive compensation plan related
13 to improvement in these areas should be assigned to the shareholders.

14 Q. What percent of the total estimated payout is related to the “Effective Use of
15 Capital” goal?

16 A. Twenty-five percent (25%). Even if the Commission were to include an
17 estimate for a future incentive plan payout in rates, the Company’s estimate should be
18 reduced 25% to exclude incentives properly assigned to the Company’s shareholders. The
19 Staff recommends that no incentive compensation payments based on financial results of the
20 corporate entity Aquila, Inc. be charged to Missouri customers of MPS. The Staff
21 finds no connection between such financial results and any benefits to MPS
22 ratepayers. The Staff’s approach to the area of incentive compensation is long-standing and
23 reflects previous Commission decisions.

1 Q. Has the Commission previously expressed views on the appropriate rate
2 treatment of incentive compensation plans?

3 A. Yes. In the Report and Order issued in Case Nos. TC-89-14, et al.,
4 Southwestern Bell Telephone Company (SWB), the Commission stated:

5 In the Commission's opinion the results of the parent corporation,
6 unregulated subsidiaries, and non-Missouri portions of SWB, are only
7 remotely related to the quality of service or the performance of SWB
8 in the state of Missouri. Achieving the goals of SBC [the parent
9 company] and unregulated subsidiaries is too remote to be a justifiable
10 cost of service for Missouri ratepayers. Accordingly, the Staff's
11 proposed disallowances in the senior management's long term and
12 short-term incentive plans...should be adopted.

13 Q. Has the Commission elsewhere addressed its views on the appropriate rate
14 treatment of incentive compensation plans?

15 A. Yes. In the Report And Order issued pursuant to Case Nos. TC-93-224, et.
16 al., SWB, the Commission reiterated its position expressed in Case No. TC-89-14, and
17 accepted the Staff's proposed disallowances of both short-term and long-term incentive costs.
18 In particular, with regard to the long-term plan, the Commission stated:

19 The structure of the plan provides an implicit incentive for participants
20 to try to increase SBC's stock price. This in turn could encourage
21 senior managers to spend a greater percentage of time on non-
22 regulated companies and discourage time and effort spent on Missouri
23 operations...The likelihood of SBC managers emphasizing whatever
24 they perceive will cause the market to react favorably to SBC stock,
25 including giving priority to unregulated subsidiaries, further convinces
26 the Commission that Missouri ratepayers should not fund the long
27 term incentives.

28 **HEALTH, DENTAL AND VISION INSURANCE**

29 Q. Please explain the Staff's proposed adjustment MPS electric: S-85.10.
30

Rebuttal Testimony of
Dana E. Eaves

1 A. The Staff's adjustments seek to account for the over-accrual that the Company
2 has experienced in prior years for health, dental and vision insurance compared to actual
3 claims paid for these items. The Company's cost for these benefits is based on both
4 insurance premiums for some of the benefits and a self-insured amount for actual claims
5 paid. The Company's adjustment to test year expense for health, dental and vision expense
6 reflects the self-insured portion of their benefit costs. The Staff's analysis of the Company's
7 prior estimates of claims paid indicates that the Company's estimates have historically been
8 higher than actual claims paid. The Staff adjustment recognizes that while the Company
9 accrues the cost of these plans in its books and records, that accrual is adjusted sometime in
10 the future based upon actual costs incurred by the Company for the payment of medical,
11 dental and vision claims.

12 Q. Does this conclude your rebuttal testimony?

13 A. Yes, it does.